Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Speier | Analyst: Jeff Garnier | Bill Number: SB 516

Related Bills: See Legislative History | Telephone: 845-5322 | Introduced Date: February 20, 2003

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: S Corporation Treatment Allowed only to Corporations with Less Than $20 Million in Total Gross Receipts

SUMMARY

This bill would restrict S corporation status to corporations with less than $20 million in total gross receipts.

PURPOSE OF THE BILL

It appears the intent of the bill is to prohibit large corporate taxpayers from being an S corporation for state purposes.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective and operative for taxable years beginning on or after January 1, 2003.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist with amendments to resolve the implementation concerns discussed in this analysis.

ANALYSIS

FEDERAL/STATE LAW

For income years beginning on or after January 1, 1987, California conformed to the federal S corporation provisions, with specified exceptions. For federal purposes, the taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, regardless of whether such income is actually distributed. The shareholders of a small business C corporation may elect to have the corporation be treated as an S corporation.

Board Position:			Department Director	Date
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Under California law, in addition to the pass-through of the S corporation's income and deductions to its shareholders, an S corporation is subject to the franchise tax, in an amount equal to the greater of the minimum tax or 1.5% of its net income for the taxable year. Unlike other corporations, however, an S corporation is allowed to compute depreciation under the modified cost recovery system (MACRS) and is subject to the same at-risk and passive activity loss rules as an individual. An S corporation is not subject to the alternative minimum tax. Credits are allowed against this corporate level tax in an amount equal to one-third of the amount otherwise allowable.
Prior to 2002, a corporation that had in effect a valid federal election to be an S corporation was an S corporation for California purposes unless the corporation elected to be a C corporation for state purposes. AB 1122 (Stats. 2002, Ch. 35) generally provided that a corporation with a valid federal S election is a California S corporation.

Existing federal law provides that if an S election was terminated, the corporation must wait five taxable years to re-elect S corporation status. Federal law provides an exception to the five-year waiting period if the IRS consents to the new election. The five-year waiting period after termination provision is included in the law to prevent taxpayers from electing in and out of S corporation status to avoid tax. California has always been in conformity with this provision, and the Franchise Tax Board has the administrative authority to allow a corporation to re-elect S corporation status within five years of termination. Due to the passage of AB 1122, providing all federal S corporations are state S Corporations, this provision is no longer a factor under California law.

Federal law also provides relief to corporations that inadvertently terminate their S status. If the IRS determines a corporation inadvertently terminated their election, the IRS may specify the termination was all or partially ineffective and the S corporation status would remain in effect for the specified period. California is in conformity with this provision, and the Franchise Tax Board also has the administrative authority to specify the termination was all or partially ineffective. Due to the passage of AB 1122, this provision is also no longer a factor under California law.

THIS BILL

This bill would permit a corporation to be an S corporation only if its total gross receipts are less than $20 million for the taxable year.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

The bill does not contain a definition of "total gross receipts," and total gross receipts is not consistently defined for broad use in the Revenue & Taxation Code. In order to avoid confusion, the author should consider including a specific definition of total gross receipts in the bill.

This bill creates an exception to AB1122, by providing only corporations with total gross receipts "for the taxable year" of less than $20 million can be an S corporation. Assume in the subsequent taxable year the corporation's total gross receipts fall below $20 million. It is unclear whether the corporation would be an S corporation under the provisions of AB 1122, be required to wait five years to become a California S corporation, or be allowed to become an S corporation in the subsequent years under the partial ineffectiveness of an inadvertent termination provision. This concern could be address by not revoking the California S status and raising the measured tax rate of 1.5% to a higher rate for S corporations with total gross receipts in excess of a certain dollar amount.

TECHNICAL CONSIDERATIONS

This bill states that only corporations with total gross receipts of less than $20 million are allowed to "elect" to be treated as an S corporation. AB 1122 provides that all corporations with a valid federal S election are California S corporations. There is no longer a separate election at the state level.

LEGISLATIVE HISTORY

AB 1122 (Stats. 2002, Ch. 35) provided that a corporation that is a valid federal S corporation is an S corporation for California purposes.

AB 967 (Chavez, 2003) would clarify that a corporation with a valid federal S election is a California S corporation. AB 967 is presently at the Assembly Desk.

AB 1622 (Wyland, 2003) appears to be a spot bill related to S corporations. AB 1622 is presently at the Assembly Desk.

SB 227 (Hollingsworth, 2003) would, for C corporations required to be S corporations beginning in 2002 (AB 1122), make the effective date of the S corporation election for state purposes the same date as the federal election to be an S corporation. SB 227 is presently at Senate Rules.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida, Illinois, *Massachusetts*, and *Minnesota* do not allow separate S corporation elections. *New York* allows a separate election for S corporation status. None of these states have a law similar to the provisions in this bill.

Michigan treats S corporations as any other business entity for purposes of imposing the "single business tax," which is Michigan's version of income tax. Therefore, Michigan's tax law is not comparable to California tax law as it relates to S corporation elections.

FISCAL IMPACT

This bill would not significantly impact the department's costs or operations.

ECONOMIC IMPACT

Revenue Estimate

Revenue Gain Assumed Enactment After June 30, 2003 ($ Millions)			
Fiscal Year	2003-04	2004-05	2005-06
Revenue Gain	785	655	705

This bill does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

Revenue impact is based on 2000 data, the latest available. Fiscal year 2003-04 has a higher revenue gain because it also includes the impact on estimated tax payments over the first half of the 2004 tax year. Approximately 5,000 corporations will be affected by the provision. The revenue analysis for this bill took into account "leakage" for some businesses that would convert to LLCs instead of C corporations.

The impact of requiring S corporations with revenues exceeding $20 million to convert to C corporations would have a positive net impact on state revenue. It is the result of numerous tax changes (both positive and negative) between "S" and "C" status at both the entity level and the shareholder level. For example, the impact on shareholders receiving dividends instead of 100% flow-through would have a negative impact on state revenue. Under current law, the tax on profits for resident "S" shareholders is projected to be $760 million (profits times tax rate) for tax year 2003. Under proposed law, the tax on dividends to resident shareholders is projected to be $480 million (profits times tax rate times the dividend rate for profits), a revenue decrease of $280 million. On a fiscal year basis, the revenue loss from the shareholder impact would be $375 million for 2003-04, representing all of the 2003 tax year, plus part of the 2004 tax year impact.

POLICY CONCERNS

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. With conformity, the taxpayer is required to know only one set of rules. Conformity also eases FTB's administration of the law by utilizing many federal forms and instructions. This bill would create a federal and state difference for a federal S corporation and a state C corporation.

LEGISLATIVE STAFF CONTACT

Jeff Garnier
Franchise Tax Board
845-5322
jeff.garnier@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
brian.putler@ftb.ca.gov